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Tax—Lease Agreements—Deductibility of "Rental" Payments as Business Expense

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RECENT FEDERAL CASES

Tax—Lease Agreements—Deductibility of "Rental" Payments as Business Expense.

During 1959 two cases involving the right to deduct as an "ordinary and necessary" business expense rental payments made pursuant to equipment lease contracts came before the Courts of Appeals of the Eighth and Ninth Circuits. Both taxpayers claimed the deductions were permissible by authority of section 162 (a) (3) of the 1954 Internal Revenue Code.[1] In both cases the Commissioner of Internal Revenue determined that the "lease" agreements were actually conditional sales contracts, the taxpayer thereby having title to the property, or that with each "rental" payment the taxpayer acquired an equity in the property. The Commissioner disallowed the expense deduction and held that the cost of the property should be capitalized. This determination was upheld by the Tax Court and each taxpayer appealed.

The first case, *Western Contracting Corp. v. Commissioner*,[2] involved the lease of heavy construction equipment used by the taxpayer on various jobs throughout the United States.

Prior to 1946, the taxpayer, hereafter referred to as Western, was engaged in "light construction work." During 1946 Western entered into several construction contracts which required the use of much heavier equipment than it owned. Because Western lacked working capital, it attempted to obtain additional funds by borrowing. When the attempt proved unsuccessful, Western entered into seventy-five written lease agreements, with ten different equipment dealers, involving ninety-three separate items of heavy construction equipment. All but three items of the equipment were new and the minimum lease periods ranged from seven to twenty-eight months with no limitations as to how the equipment should be used. The agreed rental was a flat per month rate whether the equipment was in service or not, and Western was required to pay the shipping charges both to and from the dealer's place of business.[3] None of the leases gave Western any option to purchase the equipment, but at the end of the rental period each dealer offered to sell the leased equipment to the lessee. The "purchase price" was to be computed by deducting from the list price (the price

[1] Both cases actually arose under section 23(a) (1) (A) of the 1939 Code but since the pertinent language of the 1939 and 1954 codes are identical, all references in this article will be made to the 1954 Code to avoid confusion. Section 162 (a) (3) reads as follows: "(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including ... (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the *taxpayer has not taken, or is not taking title or in which he has no equity.*" [Emphasis added.]

[2] 271 F.2d 694 (8th Cir. 1959).

[3] During the same period, Western leased thirty additional pieces of equipment, mostly used, and the Commissioner did not challenge these leases. This equipment was treated differently by Western on its books and was eventually returned to the lessor.

for which Western could have purchased the equipment at the beginning of the term) the "rental" payments made, and adding interest costs. The result obviously was that Western could wind up owning the equipment for the same price at which it could have originally purchased it on an installment basis. The offer was accepted by Western, title transferred, and the "end payment" purchase price was capitalized. Western claimed depreciation from that point.

The Tax Court found that although the leases contained no provision for purchase, there was an industry wide custom to make such an offer at the end of the term to the lessee before offering the equipment for sale to anyone else. The dealers (lessors) carried the equipment in a suspense account on their books during the terms of the leases, and only one dealer depreciated the equipment during this time, and then only at the insistence of the Commissioner's agents. Western eventually sold fifty-nine pieces of the equipment so acquired and the sales prices it received were, in most instances, at least 50% more than the "end payment." There was also testimony by several dealers that these arrangements were becoming commonplace throughout the heavy construction industry and that they were forced to agree to such terms or lose Western's business, although their prime interest was in selling, not renting, equipment.

The Tax Court concluded that, "Upon consideration of all of the evidence... it was the intention of the parties to the so-called lease agreements relating to the equipment in dispute, that the petitioner would acquire an equity in the equipment as the result of making each so-called rental payment, and that petitioner [Western] did acquire an equity in each item."[4]

On appeal, the Tax Court was reversed by the Eighth Circuit Court of Appeals. In its opinion the court pointed out that standing alone the lease agreements could not be construed to be either sales agreements or contracts to sell. There was direct evidence that the rental rates were fair and reasonable and that the "end payments" represented the fair market value of the property. Further, the record was barren of probative evidence that the agreements did not express the true intent of the parties at the time they were entered into. In answer to the contention that the offer of sale was an industry wide custom, the implication being that the taxpayer intended from the beginning to take advantage of it, the court said, "[T]he Tax Court failed to find, and our search of the record fails to reveal, any showing of Western's familiarity with this industry custom."[5] The court then went on to state that:

> In a proper case, the economic factors of the situation may be important in interpreting an agreement, and in arriving at the intent of the parties, but there is no legal basis for here holding, as the tax court in effect did, that such factors and circumstances can make a new agreement for the parties. The Tax Court fell into fundamental error by taking these circumstances and molding them to form this new agreement by reasoning that since "this is what happened, this is what the

[4] Western Contracting Corp. v. Commissioner, 1958 P-H TAX CT. REP. & MEM. DEC. ¶ 58,077 at 332.

[5] Western Contracting Corp. v. Commissioner, *supra* note 2, at 701.

> parties intended to happen." It simply does not follow that because Western ultimately acquired all 93 pieces of equipment, it therefore had the *legal right* to so acquire them.... There being no evidence that this right existed at any time prior to actual purchase, we can find no basis in law for a finding that Western was acquiring an equity in the property, within the meaning of [§162(a)(3)].... The Tax Court's conclusion... was clearly erroneous.[6]

In the second case, *Starr's Estate v. Commissioner,*[7] the taxpayer, hereafter referred to as Starr, was advised to install an automatic sprinkling system in his factory in order to reduce his premiums on fire insurance. The installation was permanent and any later attempt at removal would only result in destroying all of its value except as scrap. Starr and the manufacturer, Automatic, entered into a contract denominated as a "Lease Form of Contract." This agreement provided that the lessee, Starr, was to make five annual rental payments of $1,240 for the use of the sprinkling system. The agreement contained the usual provisions normally found in lease contracts, including the right of the lessor to remove the system in the event of default on the part of the lessee. After the initial five years, the lessee had an option to renew the contract for an additional five years at an annual rental of $32.00. The lease contained no option to purchase the system, nor did it mention what was to happen after the second five-year period expired.

Starr deducted the annual payments as ordinary business expenses. The deduction was disallowed by the Commissioner and he was upheld by the Tax Court.[8] The Tax Court found that the useful life of such a system is about twenty-three years from the date of installation, and that Automatic would sell such a system either for cash or on a five-year installment contract. The total price, with the exception of interest, was the same under either plan. There was testimony which indicated that Automatic devised the "Lease Form of Contract" to stimulate sales and, once a sprinkler system was installed, it was never removed as long as the "lessee" made all of his "rental" payments. Automatic recorded the transaction on its books as a completed sale. From these findings of fact, the Tax Court concluded that Starr acquired a substantial equity in the sprinkler system and, therefore, the "rental" payments were not ordinary business expenses.

The Ninth Circuit Court of Appeals affirmed the Tax Court, principally on the grounds that since the salvage value of such a system is negligible, "it stretches credulity to believe that the 'lessor' ever intended to or would 'come after' the system."[9] The court further stated that the Commissioner was entitled to take into consideration the practical rather than the legal effect of the transaction, particularly since there was a record on other such installations that the "lessor," after the term of the "lease" expired, had never reclaimed from those who had met their agreed payments. The *Western Contracting* case was distinguished on its facts, but in a footnote

[6] *Id.* at 701-702.
[7] 274 F.2d 294 (9th Cir. 1959).
[8] 30 T.C. 856 (1958).
[9] Starr's Estate v. Commissioner, *supra* note 7, at 295.

to its opinion the court refused to say whether they approved or disapproved the holding of the case.

A businessman may decide to lease equipment or land for any one or more of a variety of reasons which may be prompted by business or tax considerations. One writer has compiled a list of five reasons, aside from any real or imagined tax advantage, which can influence a business to lease rather than to purchase business assets:[10] (1) Leasing will make additional capital available which can then be used for other investments which provide a greater net return. (2) A smaller total capitalization is necessary when assets are leased rather than purchased.[11] (3) When equipment is leased, no additional liability is created and the balance sheet may then present a more favorable picture for credit purposes. (4) If the particular asset involved is susceptible to rapid technological improvements, leasing it may provide a more flexible business operation since the obsolete equipment can be more easily replaced by advanced models. (5) When the equipment is particularly complex, requiring highly skilled maintenance and repair, the lease agreement may provide for factory service which will, in the long run, be more economical and efficient.[12]

The primary tax advantage which motivates a decision to lease rather than to buy is that rental payments can be deducted as "ordinary and necessary" business expenses under section 162(a)(3) of the 1954 Code. However, payments made under an installment contract are not deductible expenses, and the taxpayer must recover his cost through depreciation deductions.[13] Of course, unrestricted use of the lease device would result in "depreciation on a free-wheeling basis, wholly at the taxpayer's election, allowing the cost of property to be written off in the years in which the taxpayer finds it convenient or advantageous to the business or to his own purpose."[14] Further, if the asset is land, for which no depreciation is allowed, there can be a very substantial tax savings when the land is rented rather than purchased, particularly if the taxpayer ends up owning the land anyway.

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[10] Friedman, *Lease or Purchase of Equipment: Sale or Leaseback,* N.Y.U. 14TH INST. ON FED. TAX 1427 (1956).

[11] Although purchase on an installment basis may also require less capital, it is sometimes impossible for a business with limited resources to raise even the required down payment, which in some cases may run as high as 30%.

[12] For an excellent discussion of the financial and economical factors that should be considered before entering into a leasing program, see Griesinger, *Pros and Cons of Leasing Equipment,* 33 Harv. Bus. Rev. 75 (1955), and GREENFIELD & GRIESINGER, SALE-LEASEBACKS AND LEASING IN REAL ESTATE AND EQUIPMENT TRANSACTIONS, (1958).

[13] INT. REV. CODE OF 1954, § 167. Note that the portion of the annual payments attributable to interest is a permissible deduction. INT. REV. CODE OF 1954, § 163. Many taxpayers feel that a high rental deduction taken during the years when the asset is producing its greatest income will provide them with long range tax savings. This was particularly true before the adoption of the 1954 Code which now permits accelerated depreciation methods. INT. REV. CODE OF 1954, § 167(b), (2) and (3). The accelerated depreciation methods may have removed some of the tax saving incentive for leasing equipment, but this could be returned by any change in the law. See H.R. 10491, 86th Cong., 2nd Sess. (1960), introduced February 17, 1960 which would, under certain circumstances, treat the gain from the sale of depreciated assets as ordinary rather than capital gain.

[14] Kirby, *Considerations in Business Lease Arrangements,* 34 TAXES 34, 35 (1956).

When the lease agreement is entered into for a bona fide business purpose, the Internal Revenue Service will not usually object to the deductibility of the claimed rental payments. However, because what is nominally referred to by the parties as a "lease" can easily be in fact a disguised installment purchase agreement, such transactions are carefully scrutinized to determine their true effect.

The mere existence of an option in the contract giving the lessee the right to purchase the leased property does not, by itself, indicate that the transaction is other than what it purports to be. However, exercise of the option (or later purchase of the asset when no option existed in the original contract), provided other factors are present, may cause the Commissioner to determine that the true intent of the parties was something entirely different. The primary problem confronting both the Internal Revenue Service and the courts has been to devise a legal test which can be applied in each case to determine the true nature of the transaction for tax purposes.

The basic test of the deductibility of rental payments is set out in section 162 (a) (3) of the 1954 Code. Under this paragraph there are three basic situations which, if any one of them is found to exist, will result in the rental payment not being treated as an "ordinary and necessary" business expense. The first situation is where the taxpayer has title to the property. This prevents deductibility when the payment is made pursuant to a chattel or real property mortgage. The second is where the taxpayer is "taking title" to the property. The most obvious example of this situation is payments made under a conditional sales contract. The final circumstance in which the payments cannot be deducted is where the taxpayer is acquiring an "equity" in the property. This particular situation necessarily involves the initial determination of what is meant by the term "equity" as used in the Code. One writer has referred to it as an "equitable interest."[15] If by this the author meant that the "lessee" must have a right to compel a conveyance of the property at the end of the lease period, he is incorrect. Certainly in *Starr's Estate* there was no right to compel a conveyance. A more accurate explanation is that the word is used in its business sense, and means "a capital investment in property by one who has not yet obtained full ownership."[16] It is by finding that the disputed contract meets the criteria of either the second or third provision of section 162 (a) (3) that the courts and the Internal Revenue Service will disallow any claimed deduction for alleged "rental" payments.

It is difficult to discern from reading the opinions whether the courts find that the true intent of the parties was actually to enter into a conditional sales contract, or whether they find that the parties intended the agreement to be a lease but because of the circumstances the lessee is acquiring an "equity" in the property with each payment. The first finding brings the case within the second provision of section 162 (a) (3), the latter within the third provision. Although the end result is the same under

[15] Newlin, *Leasing Industrial Machinery,* 33 TAXES 138 (1955).
[16] Note, 11 TAX L. REV. 65, 68 (1955).

either view, a more precise analysis would aid in bringing some uniformity to an already confused area.

The applicable general rules can be set out quite simply. The difficulty comes not in stating them, but rather in applying them to the particular facts at hand. For several years the Tax Court and the Commissioner were at odds with the appellate courts as to whether "economic factors" or "intention factors" should be given the most weight,[17] but they are now in substantial agreement as to the proper test.

Simply stated, the primary objective is to determine the intent of the parties as of the time of entering into the agreement,[18] giving weight to all relevant factors including the form of the agreement (although substance not form will control),[19] the reasonableness of the rental payments,[20] the conduct of the parties toward the property,[21] and toward each other.[22] The economic effect of the transaction is to be treated as just one factor pointing toward the intent of the parties.[23]

Summarized, the courts are in effect saying that if they find from all the surrounding facts and circumstances that the parties actually intended the agreement to be a conditional sale contract, even though they may have called it a "lease," the payments made will not be considered rent nor given the status of ordinary and necessary business expenses. On the other hand, even if they find that the parties actually intended to enter into a lease agreement but in addition it is determined that there is a virtual certainty that the lessee will eventually become the owner of the property, the lessee is acquiring an "equity" with each payment and therefore the payments cannot be considered as rent.

When the lease contract contains an option to purchase, it is not difficult to find that the lessee will certainly exercise it if the option price is so low in relation to the value of the property that he cannot sensibly afford to let it lapse. This determination is, theoretically, to be made at the time of making the contract, and the obvious example is the case where the option price is only nominal.[24] Presented with these facts, although the intent of the parties still controls, it is extremely difficult for the lessee to convince a court that his intent was not to enter a contract to acquire an equity in the property. But, when the option price approaches the actual fair market value of the property, the intent is not so apparent and other evidence, such

[17] Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952).

[18] Benton v. Commissioner, *supra* note 17; Rev. Rul. 540, 1955-2 Cum. Bull. 39. A recent ruling in this area indicates that the Service will consider a contractual agreement for substantially less than the useful life of the business equipment, with no provision for renewal as a lease. If, however, the taxpayer acquires the use of the equipment for the entire period of its useful life, but the payment for such use is only to extend over a relatively short period but approximates the purchase price, it will be considered as a purchase agreement. Rev. Rul. 60-122, 1960 Int. Rev. Bull. No. 14 at 9.

[19] Starr's Estate v. Commissioner, 274 F.2d 294 (9th Cir. 1959).

[20] Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956).

[21] Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956).

[22] Beus v. Commissioner, 261 F.2d 176 (9th Cir. 1958).

[23] Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952).

[24] Quartzite Stone Co., 30 T.C. 511 (1958).

as the relationship of the amount of the payments to the fair rental value, becomes much more important.[25]

Given a contract which contains no option at all, a court is faced with the even more difficult task of deciding what the intent of the parties was at the time of contracting, keeping in mind that no matter how compelling the lessee's desire to own the property might be, there is no way by which he can force the lessor to part with his ownership. The fact that at the time the court must make this decision the lessee has become the owner is immaterial. This was essentially the problem confronting the Court of Appeals in the *Western Contracting* case.

Merely reading the language of the opinion in the *Western Contracting* case would indicate that the court resolved this dilemma by holding that where there is no "legal right" in the lessee eventually to acquire the property at the time he enters into the contract, it cannot be held that he is acquiring an equity in the property, as that term is used in section 162 (a) (3).[26] If by this language the court means that before a lease without an express option can be successfully attacked it must be shown that the taxpayer had a "legal right" to acquire the property at the time of entering the contract, a new method of tax avoidance has been opened. Further, if this is the true import of the case, it is contrary to *Starr's Estate,* because when Starr entered into the agreement he had no "legal right" to acquire title in the property. Yet both courts felt the two cases were distinguishable.

The *Western Contracting* opinion also pointed out that although there was a general business practice to offer the equipment for sale to the lessee, there was no finding that the lessee knew of this practice. The court did not say whether a finding that he did know would change the result. It is difficult to see how even an express finding by the Tax Court that the lessee knew of the general practice would support a conclusion that he had any "legal right" to acquire the property. Mere knowledge or expectation does not create a legal right. Even if it were established that the parties had entered into an oral side agreement that the property would be offered to the lessee at the end of the term, the Statute of Frauds might prevent its enforcement.[27]

It is submitted that the two cases are not contrary but that they can be reconciled on the basis of the distinction between the two types of businesses and the purposes for entering into the lease agreement. The problem is not one of applying traditional property law concepts to tax problems

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[25] Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956); Haggard v. Commissioner, 241 F.2d 288 (9th Cir. 1956).

[26] See *supra* note 6 and accompanying text.

[27] The "no oral side agreement" concept first appeared in the district court in Abramson v. United States, 133 F. Supp. 677 (S.D. Iowa 1955), which also involved a construction equipment lease contract without an option to purchase. There the court found for the taxpayer and said: "There is no evidence that the plaintiff had any title or equity in any of the equipment... when the rental payments were being made.... The written lease contract provides the only evidence of any agreement, oral or written, existing between him and the lessor... [T]he practice in the trade disclosed no right on the part of plaintiff to demand sale to him, nor obligation on his part to take a conveyance...."

or of finding a "legal right," but rather it is one of discovering the true intent of the parties, a problem of proof.

The construction industry, and other industries which require large amounts of heavy equipment periodically being moved to different locations, has a constant need for immediate working capital. Employees must be paid weekly or monthly, but the contractor must usually wait for his pay until the job is substantially completed. Each new job may require a different type of equipment than any previous one, and it may be essential that the contractor have the necessary equipment available before he even submits a bid. Equipment which may perform well under certain conditions might be wholly inadequate under others, and this fact will not be known until the equipment is actually put into operation and used for a time on the job. Because some heavy construction equipment is difficult to move from one place to another, it is often necessary to use whatever is available in the immediate area, which may be of no value on some other job. For these reasons it is important that the contractor be able to lease the necessary equipment for a certain time and then, if it proves satisfactory, later purchase it from the lessor-dealer. Even though he knows that he will later be able to buy the equipment at the same price as he could have originally, a firm decision has not been made. When and if the equipment proves satisfactory, or if he feels he can sell it at a profit, he will accept the offer, but his later reasons for buying should have no effect on determining what his intention was at the time he first entered into the agreement. Therefore, it would appear that the crucial factor in the *Western Contracting* case indicating the taxpayer's intent was that the rent was "fair and reasonable."[28]

In *Starr's Estate* an entirely different picture is presented. The intent of the parties is obvious. There was no business necessity to "lease" the equipment as the primary purpose was to save on fire insurance premiums, a purpose which would be accomplished no matter what device was used to acquire the sprinkling system. Nor can it be said that the "rental" rate in the contract was the fair market rate. It is inconceivable that equipment having a useful life of twenty-three years and selling for $6,200 would command an annual rental of $1,240.[29] Although under a strict property law concept Starr had no "legal right" to acquire the property when he signed the contract, the fact remains that it was almost an absolute certainty that he would continue to have the use and possession of the system, until it became obsolete, because of the impracticality of removal. In addition, he would probably be able eventually to claim the legal title by abandonment. Therefore, the court was entirely correct in holding that the payments were not mere rental expense paid for the continued use and possession of the property.

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28 Western Contracting Corp. v. Commissioner, 271 F.2d 694, 700 n.4 (8th Cir. 1959).

29 An alternative ground upon which the deduction could have been disallowed is that the expense claimed was unreasonable in amount. Although the word "reasonable" only appears in paragraph (1) of section 162 (a), one court has held that the requirement of reasonableness is inherent in the term "ordinary and necessary." Commissioner v. Lincoln Elec. Co., 176 F.2d 815 (6th Cir. 1949).

The *Western Contracting* case, clearly correct in result, indicates the confusion which can result from attempting to apply property law concepts in the area of taxation. As it now stands the case will probably be cited by taxpayers in every case where there is a lease without an option to purchase, and other courts, like the Ninth Circuit in *Starr's Estate,* will be forced to distinguish it, neatly sidestepping the problem of whether there is or is not a "legal right" to acquire the property. Had the court omitted all reference to any "legal right" and based its opinion entirely on the practicalities and realities of the business setting in which the contract arose, as was done in *Starr's Estate,* the case would be of more value to both tax advisors and the Internal Revenue Service.

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